Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation

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PRÉCIS
Le régime fiscal canadien est fondé sur un certain nombre de notions fiscales fondamentales, lesquelles sont essentiellement appliquées pour décrire les éléments et les conséquences de l'activité financière. Cependant, d’importants aspects de l’activité financière semblent de plus en plus exister indépendamment de ces notions, ou malgré elles. En particulier, l’innovation financière sur le marché international donne lieu à des changements dans la forme et dans la nature du flux financier qui remettent en question l’utilité, la suffisance et la pertinence des normes traditionnelles en matière de politique financière et leur application réglementaire. Les conséquences de cette question sur l’évolution et l’application futures de la loi fiscale canadienne sont examinées dans cet article.

ABSTRACT
The Canadian income tax system is grounded in a number of fundamental fiscal concepts that, essentially, are applied to describe the elements and consequences of financial activity. Increasingly, however, important aspects of financial activity seem to exist apart from or in spite of those concepts. In particular, financial innovation in the international marketplace is generating changes in the form and nature of financial flows that call into question the utility, adequacy, and relevance of traditional tax policy norms and their statutory manifestations. This article examines the implications of this issue for the future development and application of Canadian tax law.

We can imagine tax commentators of 50 years ago engaged in the visionary exercise of planning for the first half-century’s work of the Canadian Tax Foundation. Would they have assumed the essential design of the tax system to be immutable in principle, or considered its elements organic and needing regular investigation and development? What assumptions underlying the system would they have marked for scrutiny? With the

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benefit of hindsight, we know that an important objective would have been to advance, through critical inquiry, the understanding and development of the tax principles grounding our system as the economic context of taxation changed.

The legacy of the foundation’s first 50 years in pursuit of this objective is the creation of a formidable body of tax research probing the norms of income and other taxation. It seems fitting, at the threshold of the foundation’s second half-century, to pause and consider whether some of the basic limits of the Canadian income tax system—those norms of taxation so thoroughly explored through the life of the foundation—can sustain the weight of dramatic and often confusing changes in the international financial marketplace, typical of what is loosely described as economic globalization.1

ECONOMIC INTEGRATION: FACING THE LIMITS OF TAXATION

Broadly, the integration of economic activity challenges national tax systems in two primary ways. With some overlap, each concerns the extent to which taxation effectively may become elective and unpredictable if its limits—how the jurisdiction to tax is formulated and expressed, and what legal benchmarks are adopted as points of reference for measuring income and charging tax—are not responsive in principle to an increasingly homogeneous international economy.

The first issue is usually associated with the transfer pricing of property and services; it concerns how to determine a proper allocation to corporate taxpayers in particular countries of income earned within an integrated multinational corporate group. No more will be said of that issue here, except to note an evolving acknowledgment by national tax systems that longstanding prescriptive standards may no longer be adequate by themselves to identify and classify corporate income and to

capture it appropriately within the tax base. There seems to be a dawning realization that what should be included in each corporation’s income for tax purposes is an approximation of its economic value or contribution relative to the group as a whole, and that tax rules need to be framed or interpreted with this in mind.

The second issue, which is the subject of this article, is whether contemporary characteristics of financial flows so defy the juristic classifications of financial assets and obligations on which the income tax law is premised as to confound the coherent interpretation and application of that law. To the extent that these flows are, and often are designed to be, beyond the prescriptive limits of a country’s tax system, and in addition are seamless and silent in their movement across borders (and, incidentally, within corporate groups), both the significance and the utility of the tax system for achieving the normative objectives of taxation—raising revenue and facilitating the implementation of social and economic policies using the tax system as a direct policy instrument—are undermined. Furthermore, unless it responds deliberately, the tax system in some respects risks becoming an easy captive of private commercial interests. Those interests are not intrinsically or necessarily bad; indeed, there is considerable merit in eliminating gratuitous tax distinctions that distort corporate finance. But neither are they always or necessarily consistent with broader public requirements and functions served by the tax system. At the heart of this very basic issue is the integration of commercial activity with the design characteristics of the tax system:

[T]he design and implementation of tax policy are among the most fascinating activities. In their formulation is revealed not only the naked play of vested interests, but also deep-seated cultural attitudes and the impress of economic exigencies. . . . [Taxation] does not so much determine the nature of social, economic, and political changes as it reflects the resolution of such changes in the fiscal arena. . . .

Tax theory may follow tax practice or precede it, but it is clear that both theory and practice generally reflect developments in the real world, in which ideas are formulated and taxes collected.4

The point, of course, is that those concerned with the tax system must continue to think about its underlying principles in the face of often disruptive commercial changes—changes that realistically cannot be

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2 For example, functional economic analysis plays, and is recognized as having, a much more significant role in transfer-pricing legislation and guidelines for evaluating reported income than the typical results of separate entity accounting analysis would suggest. This is evident in advance pricing agreement guidelines developed by revenue authorities in Canada and other countries, and in the recent publication of the Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: Part II: Applications* (Paris: OECD, 1995).

3 For example, see Charles Thelen Plambeck, “The Taxation Implications of Global Trading” (August 27, 1990), 48 Tax Notes 1143-56.

harnessed or reversed, but can only be taken into account, by the system. This does not presuppose specific conclusions or foreordain ratification of existing principles and methods. It is almost axiomatic, though, that if we do not push forward with creative and penetrating inquiry, the system may become random in its application.

TWO QUESTIONS
A feature of the modern financial marketplace is seemingly limitless financial innovation—the evolution and pervasive use of financial products, instruments, strategies, and arrangements that are or that employ “derivatives,” including hybrid and synthetic securities.\(^5\) In relation to the tax system, two questions arise. First, has financial innovation so altered the form and nature of financial flows as to imperil profoundly and fundamentally the utility, adequacy, and indeed relevance of traditional income tax policy norms and the resulting statutory mechanisms for taxing financial flows? Second, if so, what can or should we do about it?

These are extraordinarily difficult questions, worthy of the foundation’s attention in its next half-century. This discussion attempts little more than to raise these questions in a way not confined by the traditional application of existing law to specific examples of financial innovation. Given the transient and in some ways transparent dimensions of financial innovation, product-by-product evaluations of the tax rules may be only a short-term palliative concealing a much larger concern about the coherence and internal consistency of the tax system. Trying to develop and implement tax policy for products of the moment is a little like attempting to contain clouds: they are visible and have certain identifiable features, but their form and substance are in perpetual, unpredictable motion.

FINANCIAL INNOVATION AND TAX ANALYSIS
Financial innovation has for some time been recognized as a separate subject in the foundation’s literature. Primarily, this analysis has concentrated on the application of existing tax rules to complex financial instruments (synthetic and hybrid securities) and more basic derivatives (futures, forwards, swaps, and options), rather than broader policy concerns. Although it is usually acknowledged that the current tax law is frequently incapable of dealing neatly and coherently with transactions and instruments that could not possibly have been anticipated at the time

the law was drafted, the literature is directed mainly at fitting the results of financial innovation into the existing rules. Generally, questions about the basic adequacy of the structure of the taxation system in this context are not raised or developed. It should not, however, be assumed that the fundamental tenets of income tax reflected in the current rules can provide a suitable framework for deciphering the inherent characteristics of innovative financial products and evaluating their fiscal quality in predictable and principled ways.

It may be that financial innovation simply has exposed, but may not be responsible for creating, weaknesses in the basic principles of income tax law that cannot be, or be expected to be, remedied merely by statutory modification from time to time. This is an important subject for inquiry. It stands on its own apart from the formulation of detailed tax rules to deal with the fiscal results of financial innovation. In the United States, which faces precisely the same re-evaluation of its tax principles because of financial innovation, the necessity of this inquiry has been neatly summarized:

The shortcomings of the present tax treatment of financial instruments have high social costs. Uncertain rules increase compliance costs, provide opportunity for abuse, and discourage the legitimate development and use of financial instruments. Rules that are inconsistent with the underlying economics of a transaction distort behavior, lead to an inefficient allocation of resources, and have the potential of placing [a country’s] financial institutions at a competitive disadvantage in the world market.6

The real danger is that the tax system will decline into a mire of incoherent and inconsistent treatments that almost by default will depend on formal differences among economically equivalent arrangements.7 By then, even the use of basic statutory and other principles as tools to predict the implications of novel financial arrangements will have been seriously impaired. What may be required is a more profound re-evaluation of the most fundamental assumptions underlying the income tax rules, and a new approach that is not defined or confined by precise legislation. Is it unreasonable to suggest a more economic approach, supported by interpretive principles developed in the law, both to the analysis of complex financial transactions and to the interpretation, and possibly extension,

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6 See Shuldiner, supra footnote 1, at 246.
7 The inadequacy of specific tax rules in the financial area is well recognized, and in some cases seems to have directly influenced the course of legislative simplification. See the OECD’s comments, supra footnote 5, notably at paragraphs 174 and 175, as well as two consultative documents of the United Kingdom Inland Revenue, The Tax Treatment of Financial Instruments for Managing Interest Rate Risk (London: Board of Inland Revenue, August 1991) and The Taxation of Gilts and Bonds (London: Board of Inland Revenue, May 1995). Also, there seems to be a general awareness in other contexts of the need for incisive and coherent evaluations and perhaps more sophisticated regulation of various outgrowths of financial innovation: see, for example, United States, General Accounting Office Report to Congressional Requesters, Financial Derivatives: Actions Needed To Protect the Financial System (Washington, DC: US Government Printing Office, May 1994); and Canada, Office of the Superintendent of Financial Institutions, Derivatives Best Practices (Ottawa: the department, May 1995).
of tax rules that did not anticipate the kinds of circumstances to which they must apply? An outgrowth might be a more activistic role for tax administrators and courts, and routinely more confident and expansive substantial analysis by advisers, in setting and maintaining, in this context, reasonable and reasoned philosophical expectations of tax analysis.

**TAX SYSTEM ARCHITECTURE: THE BASICS**

In broad terms, an income tax charge is triggered when a taxpayer earns a measurable amount, called income, from an activity pursued to produce a positive return. This paradigm implies that the basic architecture of an effective tax system will address three considerations: the nature of income, the timing of its recognition, and its source. Leaving aside the complexity of describing “income” meaningfully, particularly when the distinction between periodic income and capital gain must be addressed, the hardest issues in the present context are generated by specific characterization, timing, and source considerations. A functional tax system requires points of reference for expressing these considerations: the circumstances of taxation must be capable of being categorized in ways that directly and reliably reflect established formal patterns of commercial and transactional behaviour.

In the financial area, our tax rules essentially distinguish between indebtedness and equity. The financial return—interest—on indebtedness is predictable and certain according to normative financial criteria; it is taxed on a modified accrual basis. Generally, it is expected to have the quality of income, and under our rules only the passage of time limits its taxation. The financial return associated with equity is less certain; there is no assurance of earnings or their distribution, and “true” equity implies the possibility of swings in value resulting in gain or loss in respect of invested capital. Normally, then, dividends are included in income only when received, and capital profit or loss is incorporated in an income determination only when an event occurs in which it may reliably be identified, valued, and considered in some manner to be within the control of the holder (for example, as proceeds from an outright disposition of an investment or when incorporated in the underlying capital of a new instrument).

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8 See Kleinbard, “Beyond Good and Evil Debt,” supra footnote 1, at 946. The brief discussion in this section of the article imports and is meant to summarize many difficult theoretical principles that are the subject of considered discussion elsewhere. I take for granted fundamental agreement on the nature of income and do not question it further, although I realize that this, too, may be a serious open question in the present context. I concentrate primarily on timing and source questions that, in a more theoretical but highly readable analysis of financial innovation, Warren, supra footnote 1, speaks of with reference to fixed and contingent payment components of a realization-based—or, probably more accurately, a modified realization-based—tax system. Realization primarily concerns the timing of income, although in the context of withholding tax it implies source questions as well.

9 As Warren notes, supra footnote 1, at 461.

10 Warren, ibid., refers to this as “yield-to-maturity” taxation.

11 Warren, ibid., refers to this as a “wait-and-see approach.”
Our rules also implicitly concede that this elementary dichotomy is oversimplified and, interestingly for this discussion, acknowledge that other arrangements can be derived from it. Hence, the tax rules make limited special provision for the treatment of certain financial arrangements whose characteristics are not confined exclusively to those of typical debt or equity (in contemporary terms, derivative and hybrid financial instruments). Examples are options on underlying property (notably, but not exclusively, shares and debt),\(^\text{12}\) convertible securities (a principal security in which an option is embedded),\(^\text{13}\) debt securities for which the stipulated division between legal interest and principal is not a reliable determinant of these components in specific cases for tax purposes,\(^\text{14}\) debt with characteristics of equity,\(^\text{15}\) equity with characteristics of debt,\(^\text{16}\) arrangements in which the interest and principal components of a whole obligation are separated,\(^\text{17}\) debt obligations that by their yield (in the form of stipulated interest or premium return) imply underlying financial transactions,\(^\text{18}\) and transactions in which securities (or certain economic attributes of them) are unconditionally transferred without being sold.\(^\text{19}\)

**FINANCIAL INNOVATION: WHAT DOES IT MEAN?**

Broadly, a product, instrument, strategy, or arrangement is financially innovative when it permits the consequences of owning primary assets or assuming primary obligations to be synthesized or simulated by gauging performance to those assets or liabilities without a direct connection by a taxpayer to them. Narrowly, financial innovation is concerned with basic “derivatives”\(^\text{20}\)—forwards, futures, options, and swaps—but there is no

\(^{12}\) Section 49 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this article are to the Act.

\(^{13}\) Sections 51 and 51.1.

\(^{14}\) Subsections 18(9.2) through (9.8).

\(^{15}\) For example, the closing words of paragraph 212(1)(b).

\(^{16}\) The various “preferred share” rules in the Act.

\(^{17}\) Income Tax Regulations, part LXX and related provisions of the Act.

\(^{18}\) Ibid.

\(^{19}\) Rules in the Act pertaining to “securities lending arrangements” and “dividend rental arrangements”: see, in particular, subsection 112(2.3); subsection 248(1), the definition of “dividend rental arrangement”; and section 260.

\(^{20}\) For specific discussions, see the references in footnote 5, supra. Also see Sean M. O’Connor, *The Development of Financial Derivatives Markets: The Canadian Experience*, Bank of Canada Technical Report no. 62 (Ottawa: Bank of Canada, 1993). Derivatives are said to “complete” financial markets by permitting investors and obligors to gain access to or limit economic effects that are uncertain in ways not directly evident in typical debt or equity arrangements. For example, obligors may be able to limit financial risk—adverse movements of variable interest rates—by taking a position directly, using a derivative, in a market that contributes to the determination of its interest obligation. On the other side, an investor may create or magnify exposure to a market, consequently increasing the integrated yield from an investment. The economic significance of derivatives and the
reason for it to be so confined. Essentially, the term “derivatives” sub-
sumes all hybrid and synthetic instruments or arrangements; often, if not
usually, they will be some combination of a primary asset or obligation
with one or a combination of the four main “derivatives.” For example, a
convertible bond is a primitive kind of hybrid security; it consists of
typical debt and an embedded option to subscribe for another security of
the issuer. Contemporary derivatives are less obvious in their composi-
tion. The indexed return on a bond, through formulations of interest and
the repayment amount, may be derived from an implicit combination of a
primary borrowing, an interest rate swap, and a foreign exchange transac-
tion implemented secondarily in a forward or future. Alternatively, the
arrangement may not bear any overt association with typical juristic clas-
sifications of financial assets and obligations. That it may be a simple
contract to make payments begs questions about the nature of those pay-
ments and how this inquiry should be conducted.

Without too much imagination, one can see why the tax system’s es-
tablished responses to income characterization, timing, and source
questions may require review. One can also see that this is not merely an
academic issue. There are many areas of interest and concern, which are
particularly acute when payments cross national borders. By what stand-
ards are payments considered to be deductible? The Act is not well suited
to the evaluation of financing charges that are not interest or transac-
tional fees. Is it possible to defer the recognition of income by changing a
primary investment into one that is derivative but produces substantially,
if not exactly, the same financial result as a direct investment? What is
the intrinsic nature of the investment? Our system is premised on an
assumption that assets and liabilities are for the most part typical, and it
deals with distortions in their economic performance for tax purposes
generally by modifying the timing of income inclusions and charges against
income. Without this point of reference, without an expectation of what
the “right” economic performance is, it is difficult to conclude whether
there is distortion and, if there is, how it ought to be remedied.

Another aspect of the classification issue is its implications for tax rules
that specifically limit the kinds of assets permitted to be held. For exam-
ple, pension plans and other deferred income arrangements are subject to
restrictions on the ownership of assets through the foreign property re-
gime. It is not clear how the Act does or should respond to simulations of
assets that themselves are not the target assets. Another issue is what the “cost amount” of a derivative is. Two possibilities come to
mind: the economic value of an investment forgone to accommodate the acquisition of a
derivative position—the present value of an investment stream effectively traded in a swap
for a stream determined differently, for example, using a swap—or, alternatively, the
(The footnote is continued on the next page.)
tax? Our tax rules persist in applying an income-tax-like regime in respect of the passive investment return earned by non-residents from Canadian investments. For the most part, these rules apply to interest, dividends, and royalty-like periodic payments that have a specific connection to an underlying asset or commercial arrangement held by the investor. If a payment is not identified or capable of being classified in this way, do the withholding tax rules simply not apply?

Are the questions of “identification” and “classification” the same question, or are we required to inquire beyond the nominative description of a payment to determine its “real” significance? Does a traditional form of investment preclude an inquiry into subordinate, underlying, or implicit financial transactions? For example, withholding tax relief for interest is denied for various kinds of indexed or contingent amounts. Does the incorporation of novel determinants in an amount described as interest obscure implicit payments that, if identified transactionally, would properly escape this limitation? In some respects, the characterization, timing, and source issues with which we are concerned are most easily appreciated in the context of withholding tax analysis. Withholding tax rules essentially are prescriptive: tax is or is not withheld on the basis of the classification of a payment. Moreover, to the extent that global integration of financial transactions causes us concern about the integrity of the tax base, the possible use of payments of unspecific origin and character in traditional legal terms presents broader financial and tax revenue concerns.

The significance of financial innovation for the integrity of the tax system is readily apparent without the need to delve into specific aspects or examples of financial innovation. The system depends on the ability to identify the nature of assets and obligations according to norms grounded in the most basic of taxation principles. Outside these limits, the system can become disoriented. Indeed, the tools of tax analysis grounded in typical financial assets and liabilities lose much of their force when confronted with arrangements seemingly formulated outside traditional legal and financial bounds. Financial theory, however, is capable of devising limitless combinations of debt- and equity-like characteristics to produce instruments that are neither the one thing nor the other. To similar effect, the form of debt or equity may simply be a device for reflecting a matrix of implicit transactions that may not be evident and do not have separate lives for the taxpayer concerned. This article is not extensive enough to include a review of specific financial instruments or products, or to pursue related theory. It does, however, clearly show that the effects of

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21 Continued . . .

22 It is not clear that notions of production or use of the sort incorporated into paragraph 212(1)(d) of the Act are sufficiently apt or comprehensive to assist in the determination of tax in this context.
financial innovation are challenging the utility of typical tax systems. Anything that undermines the reliability of the system’s classification of financial income puts at risk the coherent and consistent application of the system’s rules.  

**INNOVATION OR ALCHEMY: JOINING THE ISSUE**

Quite simply, the issue is this: does the integrated use of derivatives with primary instruments create investments or obligations that are merely the sum of their parts—parts that should be considered to retain their independent significance financially and therefore arguably for tax purposes? Or, alternatively, is the result not merely a collective instrument in the former sense but an investment or obligation that is substantially unique in legal and financial terms, and consequently (except possibly through tortuous comparative financial and tax analysis of uncertain fiscal persuasiveness, relying heavily on inferences from original tax principles) stands beyond the practical and perhaps theoretical limits of the tax system? The tax law in Canada generally eschews redetermining, through analyses or theories of economic equivalence, the tax consequences of transactions accomplished in ways that have recognized commercial significance. A useful guide for this difficult issue is a reference recently adopted by Judge Bowman:

> Often the best—and, perhaps, the only—means of determining the substance of a transaction is to refer to the result which it produced or was intended to produce. But where the same or a similar result could have been brought about by two different methods, the adoption of either method is not necessarily a mere matter of form. To argue otherwise is generally to confuse the substance with the effect: it is something like saying that two roads from one place to another are the same because they lead to the same destination.  

Yet, what happens when the tax system defines events or concepts in terms of “roads”—debt and equity, for example—but the route actually travelled is not a “road.” Transactions not contemplated by the tax system may not be alternatives or comparable in the foregoing sense to more typical legal formulations. In this situation, we become concerned not merely with disentangling economically complex relationships but,

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23 See Warren, supra footnote 1, at 465 and 469-70, where the same point is made very dramatically: "[I]ncome is generally taxed annually on a yield-to-maturity basis on financial assets with fixed returns, whereas a wait-and-see approach is usually applied to assets with contingent returns. Whatever one thinks of the fairness and efficiency consequences of this dual regime, it is workable only if the two categories of assets can be distinguished. . . . [M]odern financial theory has identified certain equivalences that allow different types of assets to be reconstructed in terms of each other. The most striking implication of these relationships for income tax policy is that, to the extent made operational, these equivalences would undermine the fundamental distinction between assets on which there are fixed returns and those on which there are not."

more important, with questioning whether the dependence, in principle, of the tax rules on basic historical expectations of economic behaviour is misdirected.

To focus this discussion, it may be helpful to consider a couple of common examples in which the application of existing tax rules is unclear and unsatisfying. The acquisition of a financial asset, or indeed any asset, with borrowed money can be simulated using an equity derivative—a swap. An investor with an interest in making a net investment in an asset could borrow the necessary funds and acquire the asset. In that event, the investor would pay financing charges (interest) to a lender and earn an investment return on the asset that would reflect periodic amounts (such as dividends) arising from it, as well as any change in its value (a capital gain or loss) between the times of its acquisition and sale. Our tax rules apply in an orderly way to this arrangement to determine when financing expense and revenue should be recognized and how non-resident recipients of amounts (interest on the funding loan or income arising from the investment) should be taxed. In this example, the taxpayer has a direct connection with the credit and asset markets, owning the acquired asset and being directly obliged on a typical funding liability.

Alternatively, the taxpayer could enter into a contract, called a swap, which replicates this arrangement economically without requiring the direct intervention of the taxpayer in the markets that are the sources of the asset and funding liability. In return for paying to the other contracting party an amount determined with reference to a typical financing charge (interest), the taxpayer is entitled to receive payments of an unspecific type that are the whole yield on an underlying asset—an amount equal to the periodic income generated by the asset plus its appreciation during the transaction period. The economic equivalence of this to a direct, funded investment is completed by the taxpayer’s obligation to pay to the counterparty the amount of any capital loss sustained between the beginning and end of the transaction.

Now the taxpayer receives swap payments and makes swap disbursements. Does a “swap” have any intrinsic legal significance, or is it merely descriptive of the fact that parties have obligated themselves contractually to make payments to each other that are unspecific in traditional legal terms? Are the payments revenue items—that is, on income, rather than capital, account? Do the amounts accrue, or should they be accounted

25 This is not meant to be a study of derivatives, and consequently a comprehensive treatment is not possible. It is acknowledged that the revenue authorities have provided some administrative guidance in this area, although it is fairly basic, and generally is confined to broad comments with respect to rather elementary arrangements. In connection with examples of the sort described and others, see Warren’s analysis of “economic equivalences,” supra footnote 1, in particular, sections B and C of his commentary at 465-73.

for on a received or receivable basis allowing for the possibility of deferral? If the taxpayer’s counterparty is a non-resident, does withholding tax apply to the amount paid that approximates funding interest? What is the cost of the contract, and are payments in respect of (as distinguished from payments arising from) the contractual right, in conventional terms, on capital or revenue account? For tax rules concerned with asset characterization, such as the foreign property rules, what is the nature of this contract? An unspecific intangible? Contingent indebtedness? A marketable security? What is its cost? These determinations are fundamental to a constructive application of the existing law. In making them, is it relevant, though perhaps not determinative, that the economic beneficiary of an asset has no legal rights to or in respect of it? Indeed, the other contracting party may not own the asset but may merely have undertaken obligations with reference to it notionally. Furthermore, in both cases, the recourse of the contracting parties is to the general credit of each other unconditionally, and not to any underlying property. The law provides little consistent or coherent indication of how these determinations should be made. The Canadian statutory response is at best inferential, and administrative guidance by revenue authorities is (understandably) analytically confined, episodic, and infrequent.27

Another example illustrates the basic characteristics of a hybrid security and its combination with one of the primary derivatives. Here, not only are there similar difficult questions about the intrinsic qualities, in formative legal and tax terms, of the hybrid, but also there is the troublesome issue whether the separate events—a borrowing implemented through the hybrid and a hedge using a swap—should be integrated to reflect the borrower’s commercial perception of the entire arrangement, which is not necessarily consistent with the perceptions or objectives of the other parties to each aspect of the arrangement—the investor in the hybrid and the contractor to the swap.

In this transaction, a “borrower” is offered the opportunity to issue a note under its medium-term note program. The note stipulates a relatively low (or high) rate of interest but provides that a multiple (or fraction) of the subscription amount (that is, the amount “advanced”) may be required to be paid at maturity, depending on the outcome of a complex formulaic calculation that effectively incorporates one or several principal derivatives relating to various financial markets (for example, currencies, interest rates, options on derivatives), such as options and forwards. The terms of the note reflect the preferences of investors28 but hold out a uniquely attractive opportunity for the “borrower” to obtain financing, provided

27 This is an observation, not a criticism. With the possible exception of certain attempts in US tax law, there is little developed tax policy or practice internationally in this area.

28 Neither financially, nor in terms of tax principles, should it be expected that the positions of investors and issuers are in any necessary respect the same or consistent. Indeed, according to Kleinbard, “Equity Derivative Products,” supra footnote 1, accepting this is an important step in addressing the tax consequences of financial innovation.
that the market behaviour anticipated in the formula turns out not to be to the investor’s advantage. To protect itself, the issuer hedges its repayment obligations using one of the principal derivatives—in this case, say, a swap. In the result, the issuer is advanced, and on the basis of the two transactions together is obligated to pay, a certain (same) amount and also secures what amounts to a variable financing cost that behaves like interest and in fact may be derived from typical interest measures.

Again, a host of timing and other questions arise. From the borrower’s perspective, the entire arrangement behaves like a typical debt issue, leaving aside the creditworthiness of the party to the hedge. Seemingly, the tax analysis should be consistent with this view. But the outcome is not that simple. For tax purposes, the two transactions would not be integrated, although income characterization issues for the hedge might be resolved with reference to the note issue if the two were sufficiently aligned. It would be necessary to evaluate the deductibility of stipulated interest and the treatment of any repayment discount or premium using existing tax principles. In view of the meaning of “principal amount” in the Act, this analysis would have to consider whether and to what extent the debt forgiveness and deep discount rules apply. A related question is whether the stipulated interest is an entire reflection of amounts generated by the note issue that should be considered to be interest. The treatment of payments on the hedge, and in particular the basis and timing of their deductibility, would be far from certain. And if the investor in the note happened to be a non-resident, any relief from withholding tax on the interest and any maturity payment could be subject to limitations applicable to various categories of notional payments—even though, had the transactions embedded within the note been implemented separately, no questions of this sort may have arisen.

Why are transactions such as this so difficult to cope with under the tax law? An easy, but unsatisfying, answer is that the law is not sophisticated or prescient enough as a collection of prescriptive rules to provide specific guidance in respect of particular combinations of primary and derivative transactions. This is an accurate, though unhelpful, observation. It may not be possible for specific statutory and regulatory law to stay ahead of financial creativity that is unpredictable in its form and sometimes ephemeral in its substance.

A more insightful observation might come from noting the one consistent element of financial innovation. The economic benefits and burdens of property ownership can be replicated without ownership; the economic attributes of being indebted can be simulated without borrowing or undertaking other typical forms of debt. A senior US Treasury official has remarked on this in noting the collision between financial innovation and the legislative expectations of tax systems:

[A number of] . . . fundamental questions . . . are constricting the further development of the tax law . . . . [A]ccepted economic and technological assumptions are breaking down, and the tax law is still relying on the old wisdom. . . .
First, [particularly relating to swaps] legal ownership has become irrelevant. Economic ownership is what matters... so that tax definitions of ownership need to be framed differently...

An equally intractable question is differentiating capital (or principal) from the income on that capital [considered with specific reference to the utility of taxation based on a distinction between interest and principal after the two aspects of a whole obligation have been severed].... As an economic matter, options have an interest component, yet the tax law has historically ignored it....

[The official] further worried that taxpayer creativity was blurring the distinction between debt and equity [with particular reference to interest deductibility and relief from withholding tax on interest].29

The architecture of the tax system is in the main an assembly of fundamental notions: direct asset ownership and direct financial liability, and distinctions between income and capital, debt and equity, and principal and interest. It is only within the last decade that the frailties of these notions, when confronted with the exigencies of financial innovation, have become apparent.30 Without them as effective points of reference, however, the tax system risks losing its direction and becoming unresponsive to changing patterns of commercial practice in ways that will imperil its integrity as law and may create gratuitous interventions, growing out of inconsistent taxation, in the way in which financial transactions are conducted. There is, however, a further complication. For the most part, the Canadian tax system assumes that financial transactions take place in typical debt or equity forms, each with a separate existence and not part of a composite whole for tax purposes despite an obvious economic interconnection.31 To

29 These observations are attributed to Treasury Deputy Assistant Secretary for Tax Policy Cynthia Beerbower, reported in “Beerbower Outlines Six Unanswered Questions Facing Policymakers” (October 10, 1994), 9 Tax Notes International 1134-35.

30 See Kleinbard, “Beyond Good and Evil Debt,” supra footnote 1, notably (by way of example), at 943-45:

When the U.S. tax rules governing interest were developed, corporate indebtedness, once incurred, tended to remain unchanged until repaid. Fixed-rate liabilities did not transmute themselves in midstream into floating-rate obligations (much less flip-flop from one currency into another) any more than tigers turned themselves into pumpkins when finished with their breakfasts....

The development of sophisticated markets, first in forwards, futures and options in financial instruments, and more recently in notional principal amount contracts, has completely changed how a corporation views its own liabilities....

[In addition to] the current fragmentary state of guidance as to the taxation of particular financial instruments... [o]ur federal income tax system traditionally has analyzed the tax characteristics of an integrated bundle of positions in financial instruments by looking at each of these positions separately, without regard to their relationship to other positions held by the taxpayer.

Kleinbard argues that the result is tax distortion that requires “rethinking the continued viability of a system of static tax analysis” (ibid., at 945).

31 Even the United States, which is more adept at economic reconstruction for tax purposes, faces difficult policy and technical questions arising from the homogenization (The footnote is continued on the next page.)
the extent that a tax distortion needs to be remedied, the approach usually is to modify the taxation of interest or dividends, rather than to advance a statutory reconstruction of the affected arrangement according to its underlying economics. The rules dealing with prepaid interest\(^\text{32}\) are an example. The economic concern was whether principal was effectively being deducted in the name of interest. Rather than recharacterize the quality of the affected payments, the rules stipulate a mechanism that controls the timing and amount of the prepaid interest deduction as interest, although the economic effect is to extract from the amount of nominal interest the principal sought to be deducted. As we see from the examples above, the formal presentation of a financial arrangement—for example, as a note—is not necessarily revealing or instructive of embedded financial transactions. Furthermore, some derivatives, notably swaps, lack any intrinsic legal significance apart from being contracts, a status that does not in principle recommend any particular result. This is not a very useful, and is hardly a determinative, start to a complex tax analysis.

WHERE NEXT? THE BASIC CHOICE: MORE RULES OR MORE LAW

When faced with difficult questions about the adequacy of integral elements of the tax system, it is easy to issue a plea for more study and better legislation. Indeed, although it might not be readily apparent, Canadian tax law has been remarkably resilient on a case-by-case basis in facing certain aspects of financial innovation. The interest accrual rules specifically contemplate the separation of principal and interest components of a debt obligation, and also various ways in which yield payments may be manipulated; the prepaid interest rules in some respects reflect financial deconstruction. Both cases adopt an essentially formulaic\(^\text{33}\) approach to taxing untraditional yield payments. Other examples are

\(^{31}\) Continued . . .

(“hybridization”) of primary financial transactions. A brief but interesting discussion, with reference to pertinent Internal Revenue Service and Treasury rulings and notices, is found in Lee A. Sheppard, “U.S. Treasury Department Stands Up to Wall Street with Notices on Equity-Flavored Debt and Ruling on Intercorporate Dividends” (May 2, 1994), 8 Tax Notes International 1182-84.

\(^{32}\) Subsections 18(9.2) through (9.8).

\(^{33}\) Warren discusses various formulaic approaches, supra footnote 1, at 477-82. In particular, for purposes of this discussion, two manifestations, in his words, are “expected value taxation” and “imputation of a return on contingent-payment assets.” An “inherent rate of return” is used to quantify an amount of contingent payments for inclusion in income. This kind of approach is evident in part LXX of the Income Tax Regulations and subsections 18(9.2) to (9.8) of the Act. Warren identifies other possible formulaic approaches, including the integration of related but legally separate transactions meant to function commercially as a unit, expense limitation, and “disaggregation” (discussed in more detail below). In this connection, it is also interesting to consider Kleinbard’s “cost of capital allowance” approach (Kleinbard, “Beyond Good and Evil Debt,” supra footnote 1), which is essentially a formulaic or objective determination of charges associated with financing outside the limits of normal legal prescription, whose analogue essentially is the .

(The footnote is continued on the next page.)

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limitations on withholding tax relief based on payment contingency, limitations on the deductibility of payments relating to financing, the securities lending and dividend rental rules, and the complex of preferred share rules that modify the taxation of dividends and returns of capital because of debt-like characteristics of these securities. Interestingly, the new mark-to-market rules applicable to shares and debt held by financial institutions effectively create a separate financial code for that class of taxpayers, which does not depend entirely on typical principles of taxing financial transactions. But the rules governing the deductibility of interest, under study since 1987, remain fundamentally unchanged conceptually and mechanically; and a project of the revenue authorities to study swaps, foreign exchange, and other financial transactions seems not to have proceeded. Disappointingly but not surprisingly, although these developments indicate an awareness of the shortcomings of the law in this area, they are not linked by any common theme, other than the fiscal policy objective of eliminating specific tax distortions once they have been discovered. It may be asking too much to expect an incremental development of the statutory law to yield more than this; however, this approach is not very useful to the conduct of prospective analyses in the tumult of financial innovation. In any event, waiting for legislative change does not help advisers and taxpayers to cope with the application of indefinite law to transactions that do not conform to traditional tax paradigms.

A pragmatic, but nevertheless reasoned, economic approach, which can be explained by or reflected in a variety of specific guises, is another possibility, although it too has weaknesses as well as detractors in the tax community. Although this approach, which in fact prevails to some extent now, is fundamentally economic, it frequently, of necessity, makes use of the financial language adopted for tax purposes—expressions such as debt, equity, dividends, and interest. The pragmatic analyst employs tools of original financial and economic analysis sometimes associated with the contemporary notions of “disaggregation,” “deconstruction,” or “bifurcation” to identify and evaluate the transactions embedded in a complex financial formulation. Effectively, this approach acknowledges, and in some respects validates, the manipulation of economically equivalent legal capital cost allowance system in the Act applied to tangible property. This is Kleinbard’s admittedly radical response to the failings of any approach, even deconstruction or disaggregation, grounded in traditional financing precepts such as interest, which may not accurately or at least adequately reflect financing expense or investment return. Kleinbard also recognizes (ibid., at 954) that “[t]here exists absolutely no relationship between how investors, on the one hand, and the issuer, on the other, view their economic positions as a result of [contingent debt] transactions.”

As observed above, these rules do not contest or reconstruct the affected transactions or instruments, but rather accept their form and for the most part modify the treatment of payments arising from them or in their context.

This is an approach that Warren, supra footnote 1, raises for broad application, primarily to address timing distortions spawned by financial innovation. See sections 142.2 to 142.6 of the Act.
formulations at the heart of contemporary financial innovation, and uses the building blocks of the new instruments and arrangements to detect their implicit qualities, which then, in a sense, are evaluated separately but cumulatively in terms of existing tax principles.

Pragmatic economic analysis may seem to offer a convenient and sensible method of applying the existing tax rules to instruments or composite arrangements that are patently beyond the anticipation and contemplation of those rules. However, its faults should be recognized as well as its positive aspects. In itself, it is not necessarily deeply principled, even though thorough legal and financial reasoning may underlie it; and it is easy to be lulled into a false sense of assurance that its results are more substantial and durable, case by case and generally, than they may in fact prove to be.

In the first place, a formative question must be addressed before one embarks on a tax analysis grounded in economic equivalence. Is the subject instrument or arrangement merely a package of legally sustainable separate transactions? If so, there is no question of economic equivalence. The purpose of a “deconstruction” or “bifurcation” analysis in this context is simply to reveal transactions that are not notional or otherwise broadly derivative of others, but really exist with a direct connection to the taxpayer. If the answer is no, implying a “true” derivative, hybrid, or synthetic, the analysis may indeed be more economic, more dependent on detecting and evaluating “equivalences” or observing analogies to transactions whose tax consequences perhaps are more settled. Then, however, other cautions are apposite.

There are at least two criticisms of economic approaches (disaggregation, deconstruction, bifurcation) that qualify the use of these techniques. The first concerns the inherent quality of many complex financial transactions. Traditional debt and equity, and returns on them, normally sustain classification for tax purposes objectively; that is, they are fundamentally unaffected by the character or objectives of a taxpayer or the use to which they are put. In contrast, the intrinsic qualities (if indeed they exist) of many innovative financial arrangements often are not evident, and in any event these qualities are likely to be coloured in important ways by context or use. The tax law is not well formulated to guide or frame a contextual analysis, despite its attractiveness as an expedient to identify and resolve difficult questions in this area with some measure of fiscal reason. Furthermore, the administrability of such an approach is problematic. Nevertheless, an awareness of the significance of context, in the company of other pragmatic considerations, may at least assist an undeniably imperfect analysis.

36 See Kleinbard, “Equity Derivative Products,” supra footnote 1, at 1355: “[T]he economic consequences of a financial product— and therefore any rational tax analysis of that product— depends entirely on context. Sometimes an equity index futures contract is a speculative investment, and sometimes it is a component of a fixed-rate, short-term borrowing. The available analytical tools simply cannot cope with the need for context-specific analysis.”
The second, related criticism is that frequently there is no single compelling economic or financial analogue, even one that is anticipated by the tax system. For example, the equity swap discussed above as a levered acquisition of underlying property also may approximate a series of forward transactions; the tax consequences of the two formulations under existing law probably are quite different. The law does not direct a conclusion.\textsuperscript{37} Similarly, the indexed note referred to in the other example may be susceptible to a variety of plausible economic evaluations, not all of which necessarily point in the same direction. For example, the economics of the transaction can be explained as the combination of a conventional loan at market interest coupled with a forward contract relating to notional underlying property; the independent and not necessarily related purchase of a zero interest obligation; and an option on, or notionally related to, underlying property or ownership of underlying property with a put of that property upon termination of the arrangement.\textsuperscript{38} For each approach, there is a sound economic analysis, which in addition can be shown to have an objective theoretical grounding in the theory of financial equivalence.\textsuperscript{39} Moreover, innovative financial transactions cannot be evaluated in isolation from their more traditional partners. Consistent policy and practice in the tax system requires that transactions of the sort disclosed by a disaggregation analysis should be taxed the same way whether used in combination or existing separately. This complicates the analysis of complex financial transactions. Not only must the analysis make sense in a substantial financial or economic way for composed transactions, but also it must not collide with the application of tax principles to “purer” transactions and instruments used by themselves.\textsuperscript{40}

Provided that probing economic analysis does not become sophistic (and thereby create an unjustified confidence in the viability of tax concepts whose inadequacy inspired the approach in the first place), it can reveal the inherent financial complication with which the tax system must deal and perhaps assist the framing of useful inquiry. Consequently, it becomes less easy simply to suggest that transactions stand completely outside the system. In using this approach, and even the traditional language of debt and equity to express its conclusions, it is important, however, not to compound the analytical difficulties by concluding that the approach is more than pragmatic. As has been observed, this is an attraction that needs to be resisted:

\begin{quote}
[A] sophisticated pragmatist might nevertheless be tempted, for reasons he would believe fully respectable, to disguise [his pragmatism]. He might
\end{quote}
think it best sometimes to pretend that he was enforcing an old and obsolete statute or a mischievous and silly precedent when he was really ignoring it. In that case he might offer his decision as a surprising “interpretation” of the statute or precedent when it is really nothing of the kind. A thoroughgoing pragmatist would regard the question whether and how far to disguise his actual decision in this way as just another strategic question. . . . This need not be an all-or-nothing decision: a pragmatist might make his conception as openly pragmatic as he dares, disguising only those elements . . . that the community is not quite ready to accept.41

If pragmatism of this sort is appealing intuitively, is there any opportunity in the present law to support its specific use as an analytical device? The Canadian tax literature does not delve very deeply into the theoretical implications of this subject. Indeed, as one commentator has observed, there may be a contrary implication to the use of deconstruction in at least one publication of Revenue Canada.42

At the outset, it is important to acknowledge the persistent, though sometimes wobbly, primacy of form in Canadian tax law.43 But what “form”? Surely it must be a form that the tax law anticipates and must imply an inquiry beyond mere legal configuration as an arrangement of unspecific or heterogeneous quality.44 When the tax system does not recognize an arrangement, there are two choices: the arrangement is outside the system entirely (a suspicious conclusion); or the limits of analysis and interpretation of the existing law must be stretched to achieve a result that is at least rational in its immediate context. I suggest that the latter approach is in fact implicit in, and a fairer expectation of, the exercise of interpreting and applying the law.

Approached in this way, the law may support and even suggest a somewhat more introspective analysis, even if a frequent result is respect for typical forms.45 But following from this, at least, is an opening to substantial analysis where there is none better available. Indeed, there is an interesting and increasing tendency in tax decisions of Canadian courts to pay attention to the commercial context of arrangements and even to determine tax consequences of transactions on that basis, despite formal

42 Interpretation Bulletin IT-96R5, May 13, 1991, which implies that embedded options in principal instruments normally would not be treated as separate transactions. This is noted by Richardson, supra footnote 5, at 10:12.
43 For example, in relation to the question whether a taxpayer’s intention changes the implications of the form of commercial arrangements, see The Queen v. Friedberg, 92 DTC 6031 (FCA), aff’d. 93 DTC 5507 (SCC).
44 See the reference to Judge Bowman’s reasons in the Continental Bank case, supra footnote 24.
45 Tax law is accessory; it can apply only after commercial arrangements have been classified in a way anticipated by the law. This is in direct contrast with an “equivalence” approach. Here, it is argued, the focus is on what the intrinsic qualities are taking into account, the context, not on what they might have been if configured differently. See The Queen v. Lagueux & Frères Inc., 74 DTC 6569 (FCTD).
transactional configuration seemingly within the expectations of the tax rules. This is evident in the reasons underlying the decision in *Mark Resources Inc. v. The Queen* and was acknowledged in passing by the Supreme Court of Canada in *Antosko et al. v. The Queen* as possibly a respectable interpretive factor where legislation is not clear.

Is this apparently evolving but somewhat undirected attention to “commercial and economic reality” more than a nascent but narrow rule of interpretation? The recent teleological approach by a Quebec court in applying tax law could be explained simply as an extension of a typical interpretive device:

The teleological approach makes it clear that in tax matters it is no longer possible to reduce the rules of interpretation to presumptions in favour of or against the taxpayer or to well-defined categories known to require a liberal, strict or literal interpretation. I refer to [the reasons of] Dickson, C.J. . . . when he says that the effort to determine the purpose of the legislation does not mean that a specific provision loses all its strictures. In other words, it is the teleological interpretation that will be the means of identifying the purpose underlying a specific legislative provision and the Act as a whole; and it is the purpose in question which will dictate in each case whether a strict or a liberal interpretation is appropriate or whether it is the tax department or the taxpayer which will be favoured [emphasis added].

But, arguably, too ready an acceptance of this teleological approach generally would be too confining both of the nature and purpose of legal interpretation as being limited by narrow interpretation principles, and of the Supreme Court’s notion here of the role and goal of interpretation in tax matters. The law does not exist for its own sake. It is meant to be applied rationally, and when its application seems impaired, the implications of context necessarily influence how the law should be interpreted. Regardless of particular outcomes, it is evident that the courts deciding these cases in fact are struggling to discover the “right” answer to real questions in circumstances where the law may admit several interpretations and, as well, the circumstances may not fall neatly into transactional categories implicit in the design of the tax system. In a sense, this tendency most evidently and directly concerns interpretive principle. But, at

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46 93 DTC 1004 (TCC) (under appeal).
47 94 DTC 6314 (SCC).
48 In *Antosko*, ibid., at 6320, the court stated: “While it is true that courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the *Act* and the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain and where the legal and practical effect of the transaction is undisputed [emphasis added].” There is a clear implication, it is suggested, that some notion of “commercial and economic reality” is more significant if the law and the “legal and practical effect” of a transaction are unclear. This tendency, or at least sensitivity, is clearly evident in Chief Justice Dickson’s reasons in *The Queen v. Bronfman Trust*, 87 DTC 5059 (SCC).
49 *Corporation Notre-Dame de Bon-Secours v. Communaute Urbaine de Quebec et al.*, 95 DTC 5017, at 5022 (SCC).
its heart, is not the application of existing law to circumstances outside its scope an interpretive exercise? What depths of transactional analysis will the law bear? Is the result of the analysis consistent with the expectations of the law?

This approach may be referred to as interpretive activism. To the extent that it is applied by the courts in elaborating principles of tax interpretation, it may produce a regime of court-made law (referring, where appropriate, to the established administrative practices of revenue authorities) in areas that are more commonly addressed by legislation. It may also inspire the confident development of administrative principles that are reliable supplements to legislation. If this interpretive approach has merit, used in combination with pragmatic tools of economic or financial analysis, two further questions arise: is this approach appropriate for tax law, and is it sufficient to support the predictable application of the law? While these are very difficult questions, they must be considered.

**THE ARGUMENT FOR INTERPRETIVE ACTIVISM: SYSTEMIC INTEGRITY**

I suggest that precise revisions of statutory law cannot be counted on to fill technical and perhaps substantial gaps in the Act revealed by financial innovation. Legislation tends to be backward looking; commercial enterprise in this area, in contrast, is driven by novelty. Moreover, legislative change may require such a fundamental rethinking of basic tax concepts and their consistent application in both simple and complex situations that the pace of change will be slower than is needed. A further complication is the unlikelihood that an international consensus will soon be reached on specific legislative directions in this area.

As I have noted, however, there are signs of support on the part of the courts in recent Canadian tax cases, and also in legal theory, for the recognition and adoption of a contextual and, in some respects, pragmatic approach to the application of tax law, both generally and in respect of financial innovation. Although the implications have not been carefully considered, there is merit in studying whether this approach should be encouraged. To the extent that technical deficiencies in the tax law defeat its evident substantial significance, this broadly purposive approach seemingly has a place.

In a penetrating evaluation of interpretive uncertainty in tax law, and what to do about it, a US tax practitioner has employed modern notions of legal theory to assert a primary goal of enhancing the integrity of the law.\(^{50}\) Essentially, he contends that the law, even the tax law, has an underlying purpose that may not always be efficiently or instructively

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revealed by statutory prescription. That, however, does not obviate the need, by constructive interpretation, to supply missing content to the law (and to expect it to be supplied) or to assist its application in difficult cases through creative but nevertheless thoughtful interpretive analysis. Implicitly, this argument extends the narrow connotations of statutory interpretation. It is also not a determining criticism that this approach would raise issues of administrability and predictability. Law, as law, requires to be interpreted with specific reference to the context in which it is to be applied.

In tax matters, it might be thought that the courts should leave it to [the legislature and treasury or finance authorities] to correct a deficiency in the statute. But, again putting aside fair notice considerations, that is a claim that must be defended. Why should courts in the area of tax law fail to perform the function of elaborating the statutory structure in a reasoned manner, drawing upon the principles and policies of the law, which our judicial practices generally recognize as an appropriate judicial function? Statutory and regulatory corrections are rarely forthcoming. And why should an answer that is wrong in principle . . . be sanctioned in the immediate case for the interim . . .

It might be claimed that notions of principle have little relevance to the tax law, in that the function of the tax law is merely to raise revenue. That specification is inadequate. The function of the tax law is to raise revenue in (among other things) a fair and equitable manner, and that qualification imports considerations of principle and equality.51

Tax practitioners faced with complex financial transactions often have an intuitive or impressionistic view of what the tax consequences should be. Just as often, however, they have difficulty finding an accepted legal explanation for that intuition or impression. Yet, there is seldom guidance in the other direction. If reliance by the tax system on formative principles of financial analysis necessarily occasions analytical uncertainty, perhaps what is required is a regime for reaching broadly acceptable, reasoned (though perhaps not principled in typical terms) decisions about how to approach financial complexity in a deliberate way, and an institutional expectation that this is the accepted course.

An immediate suggestion might rely on an administrative or judicial recognition of pragmatic economic analysis as a method, acceptable in principle as a device, for resolving intractable issues of interpretation and application. Underlying this approach, there should be a broad recognition that the consequences of financial innovation do not, and should not be expected or permitted to, stand apart from the existing law but somehow must be explained within its framework.52

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51 Smith, supra footnote 51, at 551-52.

52 The work of the foundation in sponsoring regular evaluations of financial products is an important component of this kind of analysis, but what I have in mind goes further and would not be so constrained by normative legal principles in the Act that are not very instructive, by themselves, of how the law possibly should be applied.
The goal would be to insist on the expectation that a rational and coherent application of the tax law should not be defeated simply because its underlying precepts are dated in the contemporary financial marketplace. To implement this goal, a more activist interpretive attitude is required by all concerned with taxation, notably tax administrators and the courts, but also advisers. In effect, it must be conceded that the interpretive bounds of the tax law are not clear, but it must also be recognized that they may be made clearer, case by case, in groups of transactions with similar characteristics and perhaps even in principle, by an organic expansion, where necessary, of existing tax principles. The role of pragmatic or economic analysis is to define and control this interpretive development. The point of both is to make the law work in a constructive and positively directed fashion, tempered by a thoughtful awareness of its intrinsic limits. An enlightened development of this notion, I suggest, should be part of the legacy of the foundation’s next half-century.